Australia Industrial – April 2023

SPOTLIGHT
Savills Research

The affordability of warehouse rents

The complex equations behind how much different occupiers are willing to pay

Some of the questions facing users today:

Are rental levels affordable and sustainable?

How does the location of a warehouse influence costs?

What are some of the key factors influencing site selection?

What are the impact of cost rises in the supply chain?

This report has been reproduced for Australia with the assistance of the Savills UK Commercial Research team, Hatmill and LondonMetric PLC.

Complex equations

With demand outstripping supply, what factors need to be considered when looking to take new warehouse space?

Significant structural tailwinds have amplified nearly every metric associated with the industrial and logistics property market. Take-up has risen dramatically, even as the supply pipeline builds and the vacancy rate is at less than 1.0% in most markets, its lowest level ever recorded.

Despite the current economic headwinds, occupiers are still competing for space and rents are being pushed above previous benchmarks. 2022 was a record year for rental growth, with the steepest growth rates being recorded in those locations with the lowest vacancy. In fact, since the start of 2022, rental levels have increased on average 13% nationally and nearly 24% for the east coast markets. Forecasts suggest that a further growth will be seen over the next two years.

Combined with other inflationary pressures, investors are rightly asking whether rental levels are affordable and sustainable. Savills has worked with leading supply chain consultants Hatmill and major logistics landlord LondonMetric to examine this question and we have published some of the findings in this Australian report.

Greater analysis

For the occupier, this paper will provide greater analysis around the decision-making process on what factors are considered when companies are looking to take new warehouse space.

Perceived wisdom suggests that landlords can view the affordability of rent through a narrow lens by simply looking at an individual company's turnover and profit and cut their cloth accordingly.

Rent, however, needs to be viewed as a component within a much wider cost base. The location of a warehouse, for instance, has the potential to influence costs, which in turn can impact a company's bottom line.

To examine this further, Hatmill has created a model, using anonymised data from their own consultancy work, which examines the cost base for parcel delivery companies, online retailers and traditional high street retailers. This segment of the market covers over 60% of warehouse take-up in the UK, similar to the Australian market.

Whilst manufacturing companies do make up around 15% of occupier demand, these have been excluded from the model as the analysis becomes much more bespoke depending on the type of company considered and the propensity of such companies to prefer freehold property. Hatmill has also excluded 3PLs from our analysis as, for the most part, 3PL contacts are awarded on an open book basis, meaning that any cost rises are simply passed on to the awarding retailer or manufacturer.

Introduction

Investors are rightly asking whether rental levels are affordable and sustainable

Sustainable rental levels

Our analysis examines the key cost factors occupiers are considering when choosing a new site, why this equation is both complex and constantly changing and what the property market impacts of rising rental levels could be.

The first section of our report looks at the myriad of factors occupiers are considering when searching for new warehouse accommodation. We also pick out which factors are considered to be integral to decision-making.

In the second section, the report takes data from a wide sample of occupiers and highlights that labour and transport make up the bulk of a company's total cost. However, any analysis is always a snapshot in time, meaning that the same analysis undertaken at different times in an economic cycle, or for different geographies, can yield different results.

Lastly, we examine the real estate implications that rising costs across the board have and whether different markets have the potential to react differently.

Moving forward

Given the current inflationary pressures impacting all areas of cost, it is important to stress that rising rental levels need to be seen in a wider context. At this moment in time, costs are rising for transport, energy and labour rates.

From a real estate perspective, this makes the analysis of new locations even more important as any cost savings achieved by choosing a warehouse that may have a cheaper rent will be negated by increased transport costs.

Occupiers in the sector continue to perform well financially, which, in turn, bodes well for the growing areas of the warehouse property market. Indeed, Amazon Australia's sales rose by nearly 48% last year and doubled its distribution capacity to 330,000sqm. While operational costs were elevated due to wage growth, severe weather events and labour shortages, Australia Post's road express and B2B premium service, StarTrack, has continued to increase revenue and managed higher costs to deliver a strong result. Coles's e-commerce sales grew by 41% in 2022 and on a 3-yr CAGR, Woolworths e-commerce sales have increased by 41.8%.

Despite e-commerce growth easing, growth in online retail, as a proportion of total retail sales is set to continue. The pandemic accelerated the structural growth trends in e-commerce and although this surge has started to normalise, e-commerce spend remains at high levels. This bodes well for industrial and logistics real estate demand.

As with all things real estate, location is critical, especially at a time of increasing overall costs. Occupiers will view rent affordability on a case-by-case basis in the context of how much throughput can be achieved in any given unit. In densely populated markets, where vacancy remains low and online retail continues to rise, the cost of not locating there would arguably be higher than choosing to serve the market from elsewhere.

The X factors influencing site selection:

Labour availability vs requirement

Relative labour cost rate

ESG credentials

Outbound transport cost per drop

Selecting a site

There are any number of variables in play when adding a new site to a logistic network, but processes are in place to avoid 'occupier's remorse'. As **Simon Dixon** explains

The current market for logistics property is as hot as it's ever been. With limited supply and high demand, there is significant pressure on rents to increase. That's the simplistic version that the property market likes, the operational reality is somewhat different...

When adding a new site to a logistics network, or choosing to move to a new site, the number of variables can be overwhelming. It is, therefore, unsurprising that some businesses choose to base their selection on evaluating fewer variables, particularly when the lead-time for having a new facility can be a pressing factor.

However, to avoid 'occupier's remorse', it is only through the forensic testing of all the variables that occupiers can be confident in their selection and its associated likely future cost base.

The table on page 5 shows the typical categories of influencing factors for different occupiers.

In the column underneath the table, the headings are the more specific variables that we typically use to evaluate a range of potential locations. It is only from building a complex model where each of the variables can be adjusted to represent the likely actual costs for a given site, that a comprehensive evaluation can be completed.

In many cases, it is difficult to give a variable a precise value, as it could change over time. This is where combining future scenarios, with a range of locations, is needed. This can generate many cost scenarios for a site, but once the likely extremities of the cost range are known, it is easier to make decisions with confidence. In many cases, the selection of a site is done because of how the variables manifest themselves at a moment in time. The same piece of analysis two years later could generate a different result.

n Simon Dixon is the founder and CEO of supply chain and logistics consultancy Hatmill

Network development

Lower — **Occupier's ability to influence as part of a new site project** — Higher

Labour	Customer	Inbound supply	Product	Property	Outbound shipping	Process
Labour availability vs requirement	Order to fulfilment lead time expectation or need	Time/distance from source	Product life / date code	Cost per sq ft	Outbound transport cost per drop	Storage vs throughput requirements
Relative labour cost rate	Frequency of delivery required	Can it be delivered in a legal 'driver day'	Planned consumption or Emergency/ urgent purchase	Availability of space, indoor and yard relative to needs	Vehicle type required for delivery	Level of automation deployed
Time and cost to commute to site, availability of public transport	Future network developments	Co-located with manufacturing?	Typical cube, weight and value per kg or m^3 traits of product or range	Property specifications, e.g. floor slab, height to eaves, power supply, yard, doors etc.	Use of carriers / proximity to parcel hubs	Space utilisation across 24/7
Likely future labour competitiveness	Proximity to customer base	Made to order?	Temperature band requirements	ESG credentials, including fuel options for HGVs	To RDC / to shop / direct to end user?	To RDC / to shop / direct to end user?
Competitive nature of local market with other local employers	What the customer wants vs. what they need	Proximity to rail head if inbounding containers from major ports	Future volume requirements	Future developments nearby	Ensure no time restrictions applicable to vehicle moves on/ from the site	Quantum of activities that can be efficiently on a mezzanine
Car parking availability for staff at shift changeover	Clearly defined specification of requirements	Impact/benefit on procurement cost	Hazardous goods storage requirements (legislative and insurer demands)	EV charging for staff / reduced car parking to encourage active travel		
Location of CEOs house!	Access for customer showroom			Environmental restrictions on vehicle access		

Source Hatmill

The X factors

Some examples of the detail around particular variables

Labour availability vs requirement
Australia's unemployment rate remains near its lowest level in nearly 50 years, making labour availability one of the greatest influencing factors in site selection. Low levels of appropriate labour availability start to change the design of the warehouse's processes. Increased levels of automation, including robotics, start to become more relevant to be explored. This, in turn, can start to influence the building specification and design. For example, more height might allow a higher density of product storage with an automated system. Floor slabs may need to be upgraded and additional power requirements could be needed. Alternatively, if automation is not an option, a lack of labour may just eliminate a site from an evaluation.

Relative labour cost rate
The ongoing labour rate for a particular location generally follows the laws of supply and demand, over and above any minimum wage legislation. Highly competitive areas can see pay rates being as much as 20% higher than others. Research into the local job market for numbers of vacancies, time to and fill, relative pay rates of other similar employers can help identify what a likely pay rate is going to be for a given site. Coupled with labour availability, these factors can have the biggest impact of the viability of a location.

ESG credentials
Not that long ago, developers would come forward with potential ESG initiatives, present the return on investment, and have them rejected as ideas as they didn't meet an occupier's normal investment hurdle rate. Things have changed. Businesses are actively recognising that by installing PVs, rainwater harvesting and wind turbines, they can make a positive impact on the environment, customers' perceptions of them, and lower annual operating costs. This theme is only likely to increase in importance given more recent energy cost increases.

Outbound transport cost per drop
With the increase in e-commerce, and with it an associated increase in customer expectations of short order to fulfilment lead times, many warehouse moves are predicated on businesses reshaping their supply chain to meet customer demand. A key part of this is the relationship between the fixed cost of a location and the variable cost of the transport associated with it. This is one of the most complex areas to model when evaluating a location. Key inputs into the calculation are typically: frequency of delivery, cubic size and weight of drop, lead time expectation, vehicle type to be used, density of delivery locations, time per delivery drop, number of drops per driver/van shift, and road network type.

A question of cost

The sector will continue to benefit from structural tailwinds as scarcity of supply amid sustained demand for industrial floor space strengthens the case for rental growth. **Simon Dixon** does the math

Not all logistics operations are the same. Operations in different channels and sectors have different cost structures. This is because the volume and type of activity vary depending on the output the operations are seeking to deliver.

For example, parcel and post services have significantly higher transport costs than a physical retail logistics business. In the tables on page 7 we have used a range of datasets from businesses to develop the typical cost splits for three types of logistics operation: High street retailer (no e-commerce), parcel delivery companies, and a pure play e-commerce retailer.

We have used data from between three and five similar businesses for each business type and taken an average of their % cost splits to create the three typical profiles. This method avoids the scale of any one business distorting the sample. Any similarity between these cost splits and any one particular business is entirely coincidental.

The impact of cost rises

Real estate is one of the smallest cost components among the major cost categories of supply chains. In traditional warehousing, it accounts for around 5% of total operating costs of a business. In the examples shown in the cost stack, rent accounts for around 8% for a parcel business and 13% for a pure-play e-commerce tenant.

The distribution of costs across the supply become more useful when cost increases are considered. For example, transport costs have increased by around 16% in Australia since 2019 and 12% in the UK. For a parcel business, a 12% increase will add around nine percentage points to total operating costs – a significant impact. However, a 12% increase in rent would only add around one percentage points to total operating costs.

This may lead landlords to think that rent can be increased significantly without major impacts on their tenants. However, typical net profit percentages for the sectors we are looking at here are in single digits, so the businesses remain sensitive to any cost increase.

If we look at other logistics cost increases since 2019 and those expected in the near future, we can see that the sector has experienced cost pressure throughout the P&L.

These rises, when applied to the typical operating costs of the three logistics sectors above, show that overall costs are up by around 12% since 2019, and this excludes any Ukraine-related fuel cost increases. This gives supply chain leaders a significant challenge. As their role is often to reduce supply chain costs as a % of total business costs year on year.

The challenge to deliver the required service (on time, in full and to the required quality) at the lowest possible cost has just got much more difficult. They will look at the costs across their whole P&L and seek to change the activities and structure of their supply chain to achieve the lowest possible cost. This may be through changing processes in the warehouse to reduce the labour cost, or it can be a longer-term structural change such as relocating a warehouse to a place where the sum of rent, rates, labour and transport costs are at a minimum.

Such structural changes require significant analysis, planning and investment so they can be made with minimal risk. Whilst future estimates of customer demand, business growth and cost changes are included in such exercises, decisions are inevitably made at a particular point in time.

This 'snapshot' decision then typically determines the foundation for the business' logistics cost structure, particularly transport and property costs, for the duration of a lease. It is the significance of this decision that makes property selection and associated lease costs so important to get right, and why headline rents will always be under scrutiny from occupiers.

Counting the costs

Typical split of costs for three types of logistics operation

Category	Sub-cat	High street	Parcel	E-com
Property	Rent	16%	8%	13%
Property	Rates	7%	4%	6%
Property	Utilities	4%	2%	3%
Labour	Labour	27%	10%	27%
Other	Other costs	5%	1%	1%
Transport	Transport	41%	75%	50%
		100%	**100%**	**100%**

Source: Hatmill

The cost categories we have used are:
Rent: the cost of renting the logistics property(ies)
Rates: the cost of rates for those properties
Utilities: the cost of heat, light and power, etc. for those properties
Labour: the cost of people to carry out the logistics activities
Transport: the cost of transportation of goods to the delivery point
Other: typically plant, machinery, repairs etc.

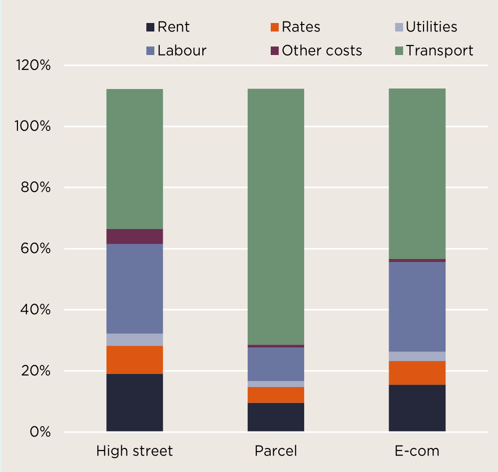
After cost increase*

Category	Sub-cat	High street	Parcel	E-com
Property	Rent	19.09%	9.54%	15.51%
Property	Rates	9.10%	5.20%	7.80%
Property	Utilities	4.00%	2.00%	3.00%
Labour	Labour	29.30%	10.85%	29.30%
Other	Other costs	5.00%	1.00%	1.00%
Transport	Transport	45.77%	83.73%	55.82%
		112.26%	**112.32%**	**112.43%**

NB: 2019 cost = 100
*Cost increases based on forecasts from Realfor, Oxford Economics and Savills analysis

Source: Hatmill

Typical operating cost splits across logistics networks post cost increases



Source: Hatmill

The right location

As online retail continues to grow, the warehouse market will see more occupiers less sensitive to rent rises, as Katy Dean, Australian Head of Research and Kevin Mofid, EMEA Head of Logistics Research for Savills examines

Location matters more than ever for occupiers. Customers are demanding next day and increasingly same day-delivery. To do that, the item needs to be close to the end-user. This minimises lead times and can reduce transportation costs.

Unsurprisingly, online retailers and parcel operators have concentrated their floorspace in the areas of the highest populations, typically in urban areas where rent is usually at a higher premium compared to the traditional outer ring, where there has previously been a tendency to cluster industry.

Yet, rent for warehouse space is the smallest cost among the major cost components in the supply chain. When we consider where goods are going, where they are coming from, and the cost of transportation to get them there, solving the equation can yield cost benefits that outweigh the rental cost.

For parcel operators and e-commerce companies, 75% and 50% of the cost stack, respectively, is taken up by transportation, costs that fall to just 41% for traditional bricks and mortar retailers.

With vacancy rates currently at record low levels and not expected to rise dramatically, coupled with rising demand from other users of warehouse space, and a restricted supply pipeline, rents on Australia's east coast are growing at a rate that is seven times its 15 year average.

For an occupier of warehouse space, location is the priority and the potential source of significant savings in the supply chain.

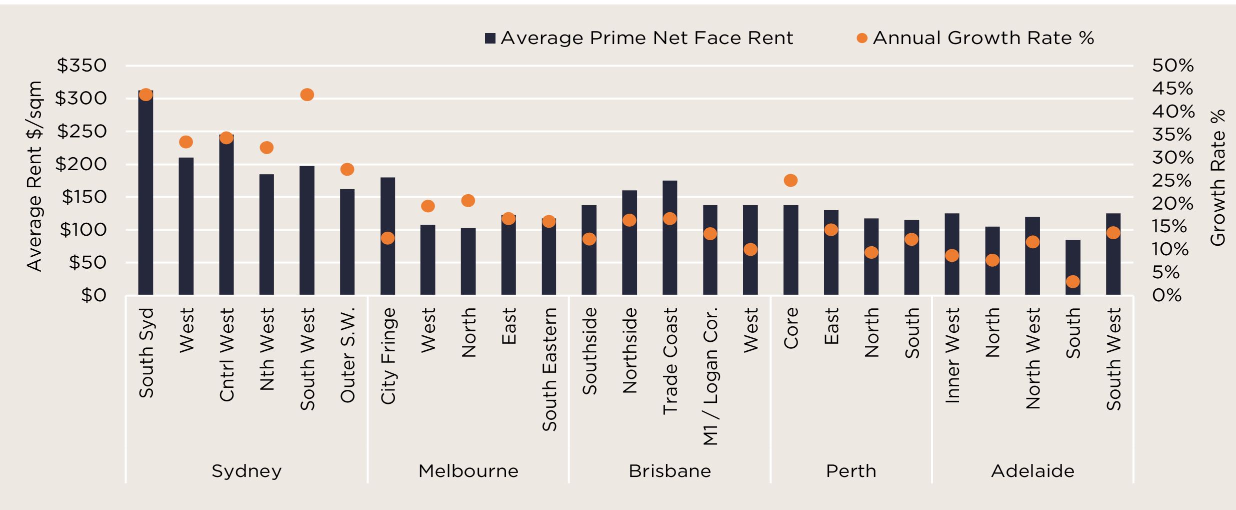
In a simple analysis, using the cost stack model, if an occupier can reduce transportation and labour costs by 1%, it provides the capacity for rent to increase by about 11%, assuming no other costs rises.

But different occupier types and different geographies will be impacted differently by rising costs. Australia is experiencing record levels of inflation, compounded by strong consumer demand and supply-chain disruption during the pandemic, Russia's invasion of Ukraine and widespread flooding across the east coast in 2022.

The inflation rate rose to 7.8% in December 2022 and forecasts put inflation in the range of 4.75% in 2023 and 3.25% by 2024. This will continue to impact energy and transport costs.

Population growth, which is expected to grow faster than projected over the next two years, before normalising to rates expected prior to the pandemic, will at a basic level increase the size of Australia's economy, including its demand for labour.

Average prime net face rent by submarket
$/sqm and annual growth rate % (Q1 2023)



Source Savills Research

For a parcel business, a 12% increase in rent would only add around one percentage point to total operating costs

Alongside the forecasts for domestic and global economic growth, Australia's overall domestic freight volumes are projected to grow by an average annual rate of 0.9% per annum, according to BITRE. Total road freight is projected to grow by an average annual rate of 1.9% per annum. In both cases, this is below the historical trend but assumes slower future growth in iron ore and coal export freight. Conversely, large-scale domestic hydrogen generation, were it to be established in the future, might give rise to significant new domestic freight task, and thus industrial demand.

Using the model on page 4 and adopting those assumptions on cost rises over the next 2-3 years, there could be some challenges for operators to control their transport costs. Labour costs are also rising, with the RBA now expecting wages to grow by 4.2% in December, before easing to 3.8% by mid-2025.

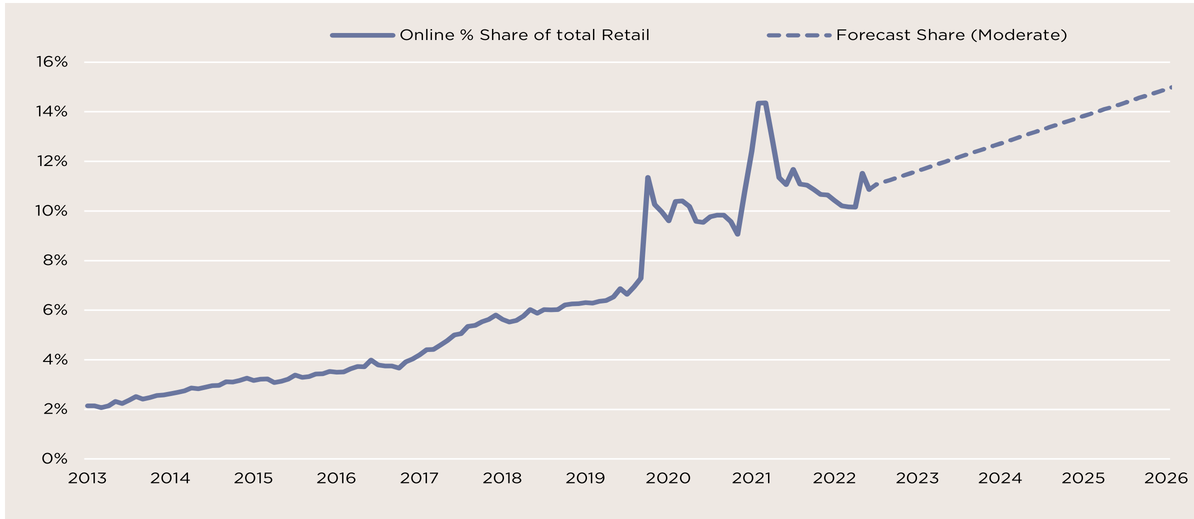
Although we are assuming that profit margins can be maintained, the cost rises could still be acute for occupiers. Rolling forward rent rises by an average of 25% based on a conservative historical CAGR for the east coast markets, means the proportion of total costs covered by rent rises to at least 10%, up from about 8% for a parcel operator in 2019.

Whilst the cost of property will be in the spotlight of company decision makers, given the cost pressures we have highlighted, it should also be noted that as the online retail segment of the retail sector continues to grow, the market available to e-commerce companies and parcel carriers will also continue to grow, and therefore margins can be maintained.

Indeed, the latest data from the ABS suggests that 2022 saw total retail sales of $35.1bn, with online sales roughly accounting for $3.86bn. Very conservatively, we expect online retail sales to account for nearly 15% of all sales by 2026. This would imply that the market will be at least 50% bigger, made up of roughly $5.9bn of sales.

This suggests the level of online spending growth outstrips any cost pressures, meaning that for a key element of the logistics property market, rent rises are manageable, all else being equal.

Share of online retail of total retail %
Australia, current and forecast



Source Savills Research / ABS

Investor opinion

Online continues to grow market share, driving revenue growth for these businesses. Ensuring occupiers have the right real estate to meet operational requirements today and in preparation for tomorrow is business-critical.

Real estate costs are a small proportion of the overall cost base, but it is large enough that asset decisions are taken seriously. Having the right asset in the right location drives efficiencies for the overall business. Being located close to your customer or supplier can mitigate other costs that are a much larger component of the total cost than the property cost.

These locations are often in short supply and compete with other land uses. As a result, the right asset in the right location is in a perfect storm of increasing demand as online market share grows and falling supply, as real estate stock is either taken up or lost to other land uses.

Andrew Smith
LondonMetric

Summary

5 KEY CONSIDERATIONS

1. Complexity

When occupiers are searching for new warehouse space, there are a huge number of key metrics which must be evaluated. These metrics vary by occupier type, by location, and the same analysis undertaken at different times can yield different results. Unfortunately, it is not as simple as suggesting that a company makes a profit or turnover of X and therefore an affordable rent is Y.

2. Key metrics

Before the widespread adoption of online retail, property costs were a much higher proportion of total costs, meaning that occupiers were much more sensitive to changes in rental levels. E-commerce and parcel delivery companies have a much higher weighting to transport costs as the cost to service the end customer is much higher than a traditional bricks-and-mortar retailer.

3. High service, low cost

The aim of the logistics manager is to deliver the highest level of service to the customer by maintaining the lowest cost base possible. In an environment where all costs are increasing at varying levels, attention will turn to the areas where the rises are causing the biggest impact on the bottom line.

4. The impact of rent rises

Warehouse rents have risen by an average of 24% since the start of 2022 on the east coast and could rise a further 25% by 2026. If we examine the total cost stack for a parcel delivery company, a 12% increase in rent would only add around one percentage point to total operating costs.

5. Future affordability

The model created by Hatmill, with LondonMetric and Savills, suggests that parcel and e-commerce companies should be preparing for furher cost rises over the next three years. If the level of online retail growth reaches forecast levels, this suggests that the market will be 50% bigger, meaning margins will be maintained and rent rises are manageable, all else being equal.

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